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INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

June 30, 2015

After a blistering start to the year, a number of international equity markets took a breather in the June quarter, including Germany (-8.53%), France (-2.58%) and the UK (-1.52%). Greece's game of chicken with creditors rattled investors, as volatility crept back into view despite the European Central Bank's (ECB) best efforts to prop up asset prices through its €1 trillion quantitative easing (QE) program. Japan was a notable exception, as the local market gained 5.73%, seemingly unfazed.[1] Meanwhile, FMI International portfolios fell by approximately 1.8% in the quarter, which compares with an MSCI EAFE Index decline of 1.82% in local currency and a gain of 0.62% in U.S. Dollars (USD). Performance was aided by the Technology Services, Consumer Durables, and Retail Trade sectors, while Finance, Electronic Technology and Distribution Services were a drag on results. Amorepacific, Accenture, and Hyundai GreenFood were the strongest individual contributors, offset by subpar performance from Fairfax Financial, Jardine Strategic and Rolls-Royce. In what continues to be a challenging investment landscape characterized by high valuations and weak business fundamentals, we remain cautious and selective.

We exited three positions in the quarter. We sold Schindler (SCHP VX) due to a run-up in the valuation and increasing risks in China, and Taiwan Secom (9917 TT) due to valuation and liquidity constraints. We also parted ways with Royal Dutch Shell (RDSA LN), as the company's fully-priced $70 billion acquisition of BG Group will reduce much needed flexibility and may present integration challenges. We opportunistically added to and trimmed several other positions in the period.

As a reminder, we strive to identify high-quality businesses that are run by strong management teams and priced at attractive valuations. We want to own durable franchises with sustainable economic moats, enabling the businesses to earn a return on invested capital (ROIC) in excess of their cost of capital. Often there is a cloud hovering over our companies, but one that we believe is transitory in nature and will eventually clear. We have a long-term investment horizon and let time work to our advantage. Our team employs a value-oriented approach that has been fine-tuned over 35+ years, with a contrarian mindset and a focus on in-depth fundamental research and security analysis. Downside protection is paramount, as we require an adequate margin of safety before deploying shareholder capital.

With stock prices up significantly over the past few years (courtesy of experimental central bank and government policies), it makes the equation far less attractive (risk vs. reward). Given the valuation environment, a significant pullback in global equity markets appears overdue, and therefore our cash level is higher than normal as we simply can't find enough attractive investment opportunities. While we would love to deploy the excess cash immediately, we are not willing to sacrifice our valuation discipline and succumb to herd behavior. We are only going to invest when we believe the long-term story is on our side. We will not chase short-term returns solely on the merits of "relative value."

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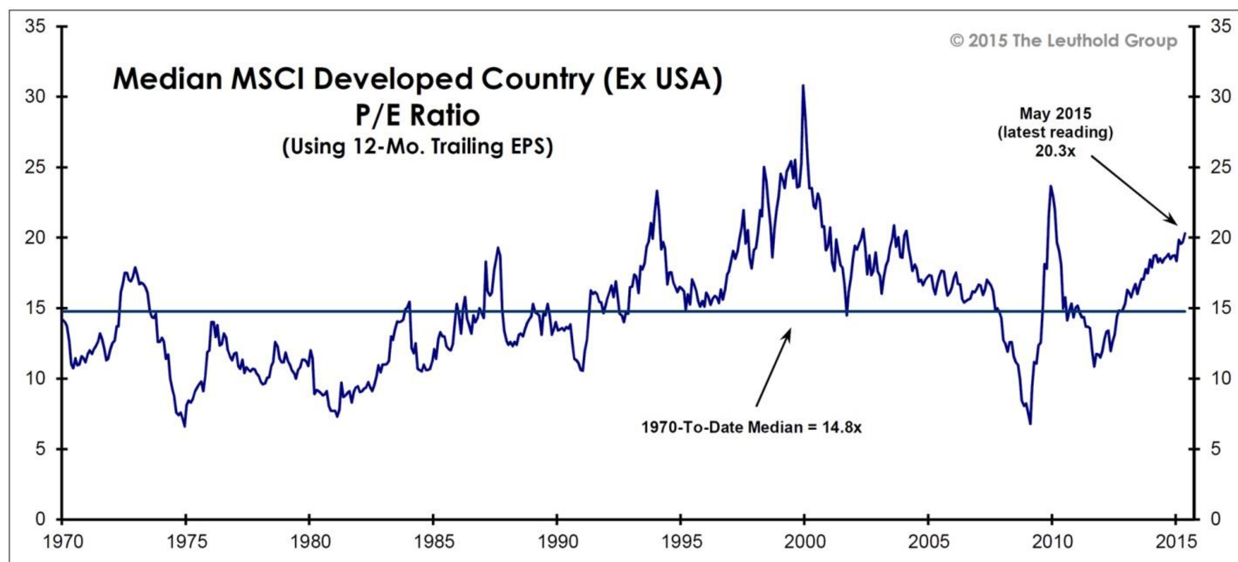
[1] The following market indexes are being referred to above: Japan TOPIX, UK FTSE All-Share, France CAC, and Germany DAX.



We would also like to remind our investors that we hedge foreign currencies, with the goal of ensuring that our performance is a reflection of our stock selection rather than the volatile swings of foreign exchange rates. While hedging had a relatively neutral impact in 2011-13, it amounted to a notable tailwind in 2014 and the first quarter of 2015. When the U.S. Dollar weakens, however, as was the case in the second quarter, we can find ourselves on the other side of the coin.

In evaluating the portfolio's underperformance year-to-date, cash was a significant drag vs. the MSCI EAFE Index (local currency), accounting for nearly half of the shortfall. An underweight exposure to the Japanese stock market appears to explain the remainder of underperformance. Admittedly, we have also had some stocks that haven't performed very well. Potash Corporation, as one example, is a story where we really like the long-term thesis, but the short-term fundamentals have resulted in a black eye. It remains a top holding.

Unprecedented Moral Hazard

Moral hazard can be defined as "a situation in which people or organizations do not suffer from the results of their bad decisions [someone else bears the burden], so may increase the risks they take."[2] In recent years, it has often been described as a problem associated with government bailouts and bank rescues ("too big to fail"), which leads to a lack of accountability and excessive risk-taking. This can result in the formation of asset bubbles. In Europe it has become a dangerous game, as governments and banks are continuously propped up by the Troika (ECB, the European Commission [EC], and the International Monetary Fund [IMF]), yet necessary structural economic reforms are often watered down or endlessly delayed. In China, implicit and explicit backing from the central and local government has led to corporate mal-investment and overcapacity, with the consequences from a potential real estate bubble and credit crisis possibly looming on the horizon. The long-term ramifications of the financial crisis in the United States, a case in point for moral hazard with reckless subprime lending practices and a number of corporate bailouts, are yet to be fully determined. Ultimately it's the tax payers who may be the ones left on the hook, as the free market approach (where entities are actually allowed to fail) is left by the wayside.

Unfortunately, experimental money printing policies (quantitative easing or QE) across the globe have temporarily papered over some of the underlying problems, creating an even deeper layer of moral hazard.

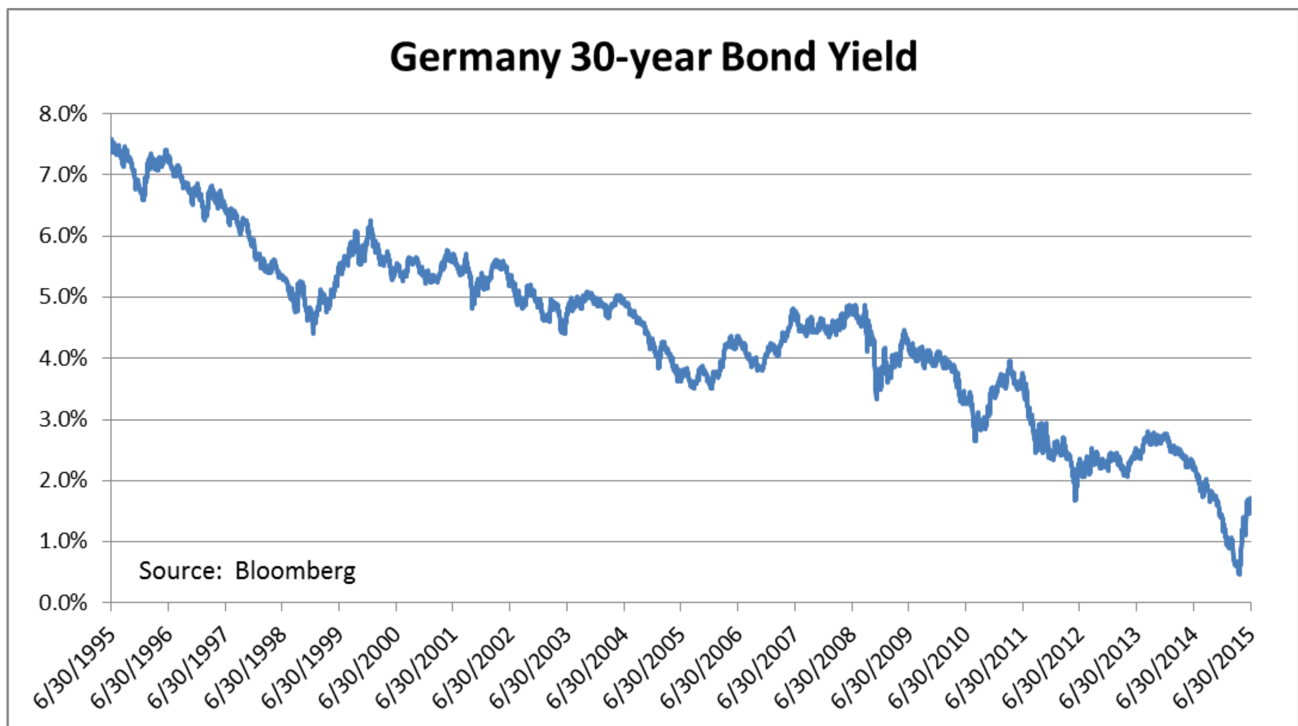
[2] Cambridge Business English Dictionary; Wikipedia.com.

Central bank pledges in Europe and Japan to "do whatever it takes" have helped lead to the notion of a "Draghi Put" or "Abe Put," and this perceived financial backstop has given investors a false sense of security. With interest rates artificially suppressed (and in some cases negative), asset prices have soared as investors stretch for yield with little regard for risk. Markets have become frothy in a number of geographies and asset classes, as many investors expect central banks to come to the rescue when the going gets tough. Additional risks of QE include the creation of zombie companies (firms that would disappear in a normal interest rate environment), currency wars, credit bubbles, emerging market capital flows, inflation, weak government incentives to embrace reform, and a slew of unintended consequences.

Meanwhile, as numerous equity and bond markets have recently hit new highs, the Organisation for Economic Co-operation and Development (OECD) predicts that global Gross Domestic Product (GDP) growth is slowing, at only 3.1% in 2015, which is a sharp downgrade from a November forecast of 3.7%. At some point the growing disconnect between asset prices and economic reality will have to be reconciled.

Europe: Risk-Free Rate

Government bonds from AAA-rated countries are about as close to a risk-free investment as you can make, or so most investors believe. While this might be a common perception, it is hardly the case today, especially when examining long-term bonds in Germany, Europe's supposed stalwart. The 30-year German Bond, which peaked at a yield of 0.46% on April 20, 2015, is illustrative.[3] If yields were to normalize, and this bond's yield was to increase to its 10-year average of 3.29%, the price would fall by 46.82% from its April high. If yields increased to their 20-year average of 4.42%, the price would fall by 57.34%. These illustrations simply embed a reversion to the mean, let alone a more distressed scenario such as a breakup of the eurozone.



[3] April 20, 2015; Source: Bloomberg.

How many investors go into a “risk-free” asset thinking that they can lose 50%+ of their principal? Not many, we suspect. Sure, investors can hold the bond to maturity and may not lose money (assuming Germany satisfies its debt), but they take enormous inflation risk to collect a paltry coupon along the way. Unfortunately not everyone has such a flexible time horizon, and some will be forced to sell at a loss. In fact, less than two months after hitting its peak, the 30-year German Bond yield jumped to 1.72% on June 26, 2015, meaning those who bought at the top faced a 25.46% write-down if forced to mark-to-market. It will take over 16 years of coupon payments to offset that loss. That is hardly risk-free.

Those that have cycled out of stocks (which are also expensive) and into bonds for safety, may soon realize that they have entered into an even riskier asset class. Current fixed income price levels are reliant on exceptionally low interest rates, which we do not view as sustainable over the long term. Money is not supposed to be free, and won’t stay that way forever. We would much rather be positioned in stocks with more reasonable valuations, better flexibility, and at least some modest upside potential.

<u>Greece: Bailout #3?</u>

Regardless of the will of the Greek people in any “referendum,” the real question is whether the Troika will bail out Greece for a third time, and what precedent will be set. Greece has essentially defaulted on their IMF loans and is clearly insolvent. What kind of message does a third bailout send to Portugal, Spain and Italy, or whoever else comes next? How big of a moral hazard will it create? The Troika may continue to extend and pretend, but it will not change the underlying reality that a number of countries in the eurozone are uncompetitive, and won’t be able to grow their way out of this debt crisis. We have long questioned the eurozone as a workable construct, arguing that a monetary union without a political and fiscal union will not work. Greece may end up being the poster child in this debacle, but it is merely a symptom of a monetary system that is not sustainable. If and when the facts change, we will evaluate the situation with an open mind, but for the time being we remain highly skeptical.

<u>Chinese Stock Markets: A Melt-up</u>

As China’s GDP growth continues to slide, it appears that speculative investors have shifted their focus from the country’s stumbling property bubble, into an increasingly volatile stock market bubble. The Shanghai Composite Index (now open to foreign investors) and Shenzen Composite Index have gained 113.1% and 126.0%, respectively, over the past 12 months, setting new 7-year highs along the way. These figures incorporate a very sharp correction late in the second quarter. Shanghai Composite-listed companies are trading at an average price-to-earnings ratio of 21.6x, which is above its 10-year average of 20.0x, but the more speculative Shenzen Composite (exposure to small cap and technology companies) is trading at a nosebleed 60.6x earnings, up from around 35x at the start of the year.[4] Median earnings multiples for Chinese technology stocks recently reached more than twice that of U.S. peers at the dot.com peak, according to Deutsche Bank.[5]

The breadth of new investors entering the stock market is staggering, with new local stock market accounts opening up at a rate of 1.4 million per week over recent weeks, up from about 70,000 a year ago. New accounts in the first few months of the year had already eclipsed the total for 2012 and 2013 combined. The central government is pushing the agenda, reportedly having state-run media companies publish educational articles encouraging stock investing.[6] *Forbes* reports that, “Many of these new players appear to be

[4] Source: Bloomberg.
[5] “Crazy Facts About China's Stock Market That Will Make You Think Twice Before Investing.” Forbes.com, April 21, 2015.
[6] Anthony Fensom. “China’s Stock Bubble.” *The Diplomat*, April 29, 2015.

inexperienced retail investors, who are likely following the advice of friends or state-controlled media," and that about two-thirds of them "left school before the age of 15," according to a China Household Finance Survey.[5, 7, 8] This does not appear to be a recipe for success.

To make matters worse, many investors are borrowing money to enhance returns, with official margin balances climbing to a record level of 2.3 trillion yuan ($371 billion) as of June 19, 2015, up more than seven times from 300 billion yuan 18 months ago. An additional 500 billion to 1 trillion yuan of margin lending is reportedly being pumped into the market through unofficial third parties.[7, 9] More than 4,000 new Chinese hedge and private equity funds have opened in the last three months, while mutual fund assets have also reached record highs.[10] The central bank has also cut the reserve requirement for banks by 100 basis points, freeing up additional funds which can now be allocated to equity investments. At one point, the total value of the Chinese stock market exceeded $10 trillion. Investor enthusiasm has been further emboldened by monetary easing, as China's central bank has cut interest rates four times since November. The latest cut appeared to be triggered by China's 7%+ stock price correction on Friday, June 26, a direct attempt by the central bank to support the market.[11, 12]

With debt levels in China already exceeding $28 trillion, including government, corporate and household debt (or 282% of annual economic output),[13] we can add an epic margin-fueled stock market bubble to a growing list of potential dangers for China.

In a recent Bank of America Merrill Lynch study, their analysts concluded that we are in the midst of a global capital expenditure slowdown, driven by reduced activity out of China. Using the Gross Fixed Capital Formation (GFCF) metric from the World Bank, it appears that China accounted for 75% of the growth in GFCF since 2008. GFCF was actually slightly below GDP growth (0.8x) in the 1990s before accelerating to 1.6x since 2009 as China ramped its stimulus spending. Using representative data sets such as electricity consumption and rail car loadings, the analysts believe that when the final GFCF figures are released, it will show a dramatic slowdown in 2014/2015. Furthermore, they think GFCF will revert back to the levels seen in the 1990s as China digests an overbuilt infrastructure. We agree with the authors' conclusion that, at least in the near-term, this phenomenon will favor investments in higher-quality, generally less cyclical or commodity-oriented investments. This is part of the reason we have been reluctant to invest in deeper cyclicals such as energy, as this transition could take years to play out. Instead, we have favored global staples such as Nestlé, Unilever and Danone, which we are holding a bit longer than normal due to the current environment. Of course, one must always view these elements in the context of valuation. If the valuation gap between the less cyclical and the more cyclical becomes too wide, it negates this strategy.

While we can't predict when global stock markets will normalize, we have a great deal of confidence that they eventually will. In the meantime, we will use valuation as our guide, and remain steadfast in our search for absolute value. Eventually our patience and conservatism should be rewarded.

Thank you for your support of Fiduciary Management, Inc.

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[7] Kopin Tan. "China's Raging Bull." *Barron's*, May 4, 2015.
[8] "China stock market saw 1.4 mln new investors last week, record margin debt." Reuters.com, June 18, 2015.
[9] Gabriel Wildau. "Chinese investors blame share collapse on state." *Financial Times*, July 2, 2015.
[10] Gabriel Wildau. "China's hedge fund industry blooms as stocks surge." *Financial Times*, June 14, 2015.
[11] Patti Waldmeir. "China cuts interest rates for third time in six months." *Financial Times*, May 11, 2015.
[12] Petar Kujundzic. "China makes big cut in bank reserve requirement to fight slowdown." Reuters.com, April 19, 2015.
[13] Enda Curran Lianting Tu. "China Has a Massive Debt Problem." Bloomberg.com, April 22, 2015.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 03/31/2015

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation Composite	*Benchmark	Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
2011	-0.78	-1.52	-12.15	1	0.00	n/a	n/a	$ 16.7	$ 12,273.6	0.14%
2012	19.35	18.46	17.31	1	0.00	n/a	n/a	$ 76.3	$ 15,253.5	0.50%
2013	25.89	24.95	26.93	1	0.00	9.78	12.22	$ 165.8	$ 19,705.3	0.84%
2014	5.66	4.87	5.92	1	0.00	7.49	10.33	$ 771.6	$ 21,001.1	3.67%
Q1 2015	8.22	8.02	10.85	1	0.00	7.31	10.66	$ 1,674.6	$ 21,939.0	7.63%

*MSCI EAFE Net Local Index®

Returns reflect the reinvestment of dividends and other earnings.
The above table reflects past performance. Past performance does not guarantee future results. A client's investment return may be lower or higher than the performance shown above. Clients may suffer an investment loss.

Fiduciary Management, Incorporated (FMI) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. FMI has been independently verified for the periods 12/31/1993 - 03/31/2015. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The International Equity Composite has been examined for the periods 12/31/2010-03/31/2015. The verification and performance examination reports are available upon request. Benchmark returns are not covered by the report of independent verifiers.

FMI was founded in 1980 and is an independent investment counseling firm registered with the SEC and the State of Wisconsin. The firm manages over $21.9 billion in assets of pension and profit sharing trusts, mutual funds, Taft-Hartley funds, insurance company portfolios, endowments and personal trusts. The firm includes both institutional and mutual fund business. Although the firm has participated in wrap programs, it is a separate and distinct business, and is excluded from firm-wide assets.

The International Equity Composite was created on December 31, 2010. This composite invests mainly in a limited number (usually between 25-35) of large capitalization (namely, companies with more than $5 billion market capitalization) foreign companies.

The International Equity Composite reflects time-weighted and asset-weighted returns for all discretionary accounts. All returns are calculated using United States Dollars and are based on monthly valuations using trade date accounting. All accounts in this composite are fee paying. Gross of fees returns are calculated gross of management fees, gross of custodial fees, gross of withholding taxes and net of transaction costs. Net of fees returns are calculated net of actual management fees and transaction costs and gross of custodial fees and withholding taxes. Dispersion is calculated using the equal weighted standard deviation of all accounts in the composite for the entire period. As of 12/31/2011, the trailing three year annualized ex-post standard deviation for the Composite and Benchmark are required to be stated per GIPS®. For the periods 2011-2012, the information is not available for the International Equity Composite.

Currently, the advisory fee structure for the International Equity Composite portfolios is as follows:
All assets at 1.00% -- Current Expense Ratio. This includes a management fee of 0.75%.

The firm generally requires a minimum of $25 million in assets to establish a discretionary account. The minimum account sizes do not apply to new accounts for which there is a corporate, family, or other substantial relationship to existing accounts. In addition, the firm reserves the right to waive the minimum account size and minimum annual fee under certain circumstances. A complete list and description of all firm composites is available upon request. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The MSCI EAFE Net Local Index® is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Net Local Index consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. It is reported in local currency and net of hedges. The International Equity composite uses the MSCI EAFE Net Local Index® as its primary index comparison.